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CIBC CAPITAL MARKETS

EQUITY RESEARCH

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August 18, 2024 **Industry Update**

The Rotation Into High Yielding Canadian Equities Is Just Beginning

$220 Billion Of Yield Demand Will Need A New Home If Rates Keep Falling

Sector:
Portfolio Strategy

Our Conclusion

Dividend investors in Canada have experienced a difficult couple years. The emergence of AI as an investable theme and the spike in short-term interest rates have resulted in an extended period of disappointing relative returns. We believe a rotation back into high yielding equities such as Utilities, REITs and Communications is just beginning.

Traditionally, Canadians have had few options to earn attractive yields outside of dividend paying equities. With the development and marketing of high interest ETFs and mutual funds along with the moves by the Bank of Canada, over $200 billion of funds flow that would likely have bought high yielding equities flooded into fixed income alternatives. If short rates follow their current trajectory, we expect to see much of these funds return to yield sectors.

Key Points

By tracking funds flow into term deposits, money market and high interest saving mutual funds and ETFs, we can show that there are roughly $220 billion in “excess” funds that Canadian individual investors have shifted into fixed income. As rates fall, these products will become much less attractive vis-à-vis high yielding equities.

Historically, Canadians have had very limited alternatives when searching for yield. Canada has a dearth of high yielding corporate bonds and no municipal bond market, and investors have been faced with low yields on government securities for decades. Traditionally, that hunger for yield has been satiated by defensive high yielding equities. That all changed in the past two years as overnight rates spiked and financial services providers developed and marketed products such as High Interest ETFs.

Extremely strong earnings growth in Technology stocks as well as specific challenges have also created headwinds for Canadian yield sectors. Communications stocks are facing aggressive price competition and regulatory challenges, Real Estate companies have long-term COVID effects and Banks continue to face rising loan losses.

This having been said, if rates continue to fall, there could be incremental demand equating to 15% of the market capitalization of Canada’s Utilities, REITs, Telecoms and Financials. We believe Canadian investors should continue rotating into these sectors in the coming months.

All figures in Canadian dollars unless otherwise stated.

For required regulatory disclosures please refer to "Important Disclosures" beginning on page 9.

A Changing Environment With Additional Choice

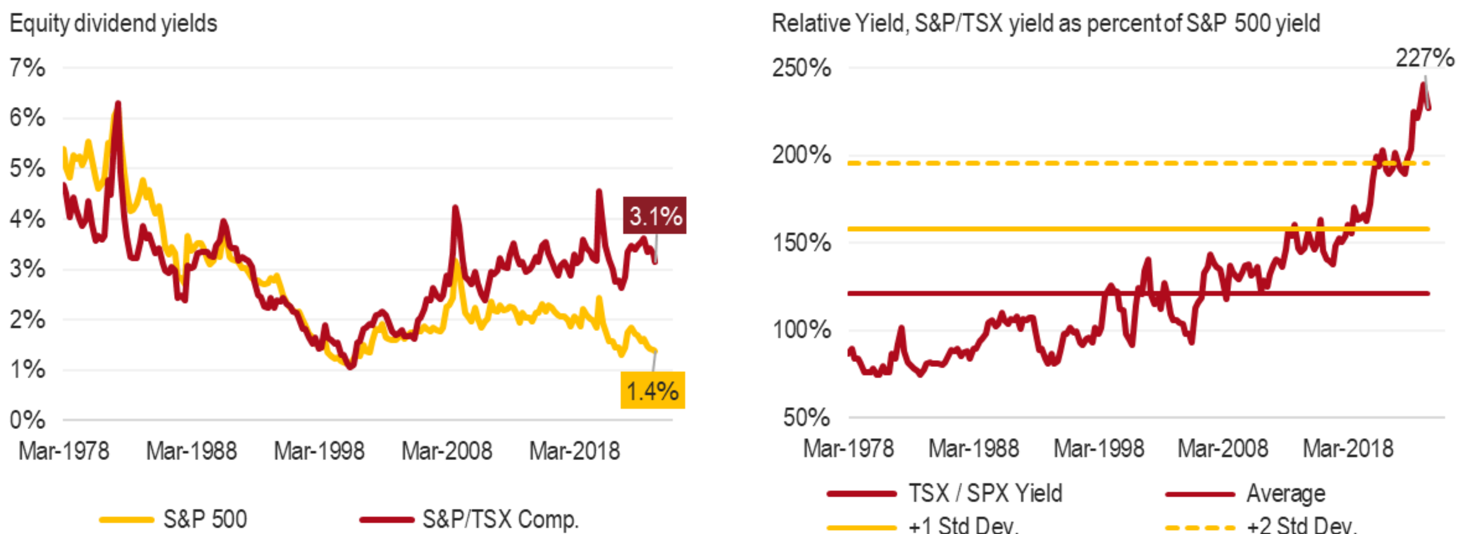
Canadian investors have always struggled to find yield. Unlike the U.S., there are very few options for "high" nominal yield – there is no Canadian municipal bond market and the high yield bond market north of the border is extremely narrow. Additionally, individual investors have traditionally had limited ability to participate in corporate bond underwritings. As a result, Canadian dividend paying equities have often played an important role in filling the void – particularly given the tax preferred nature of dividends versus fixed income yield.

Overnight rates of over 5% and HISA ETFs have changed the playing field.

Two developments over the past decade have provided valid alternatives for yield hungry Canadians. First, the spike in interest rates has produced low risk securities with attractive yields. Second, although investors have always had the option of owning bond and money market mutual funds, the emergence (and proliferation) of fixed income ETFs has added additional momentum in the shift away from high yielding equities. The net effect of higher yields and more "targeted" yield products has anecdotally resulted in less demand for traditional higher yielding equities.

We believe the changing environment has been more harmful for Canadian dividend paying equities than for U.S. dividend payers. At a high level, the yield on Canadian equities has never been this attractive when compared to U.S. equities. As we show in Exhibit 1, the yield on the S&P/TSX is now more than twice that offered by the S&P 500 – and is currently well over two standard deviations away from the historical average of the past half century.

Exhibit 1: Relative Yields – Canadian And U.S. Equity Dividend Yield, 1978-2024



Source: Bloomberg, TSE and CIBC World Markets Inc.

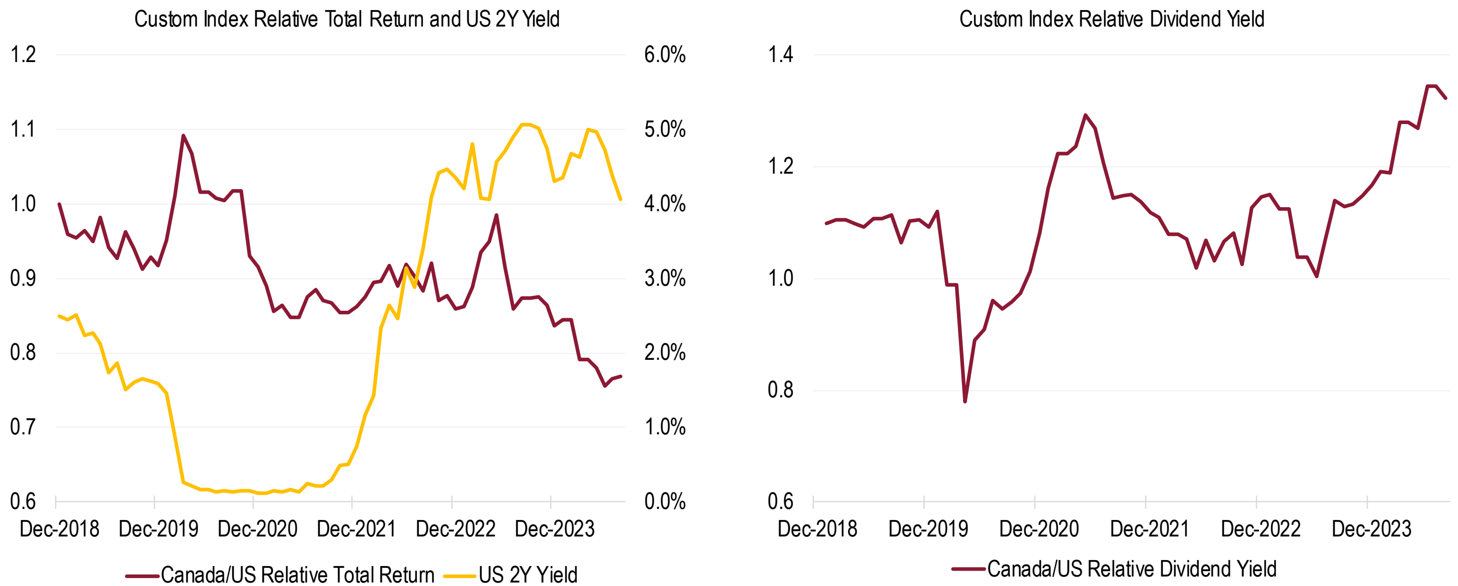
To be clear, there are several crucial reasons for this gap, beyond simple funds flow. The composition of the S&P 500 has shifted substantially towards growth companies, particularly the "Magnificent Seven". As such, valuation comparisons between the U.S. and Canada are stretched, whether one focuses on dividend yield, price to earnings, price to cashflow or price to book value.

Just compare high yield stocks in Canada and the U.S.

One way to try to "normalize" for the sector differences between the two indices is to only consider a comparable list of Canadian and American securities. To do this, we created a list of 20 traditional dividend yielders in Canada and the U.S., and looked at how these securities traded as interest rates rose. We show the "comparable" names in Appendix 1 and limit our time frame to the past five years (as all companies change over time).

As we show in Exhibit 2, the Canadian yield companies have generally underperformed their U.S. peers, and relative yield has increased in Canada. Within both charts, there are two periods of noticeable variance from the trend of Canadian underperformance. In the early days of COVID, the perceived defensiveness of Canadian Financials and Telecoms provided temporary support, i.e., Canadian "yieldcos" rallied versus their U.S. counterparts. In the second period in spring 2023, the collapse of Silicon Valley dragged U.S. Financials meaningfully lower while Canadian Financials were significantly less affected by the turmoil (note Financials make up 20% of both custom yield indices).

Exhibit 2: Custom Yield Indices (Canada And U.S.) – Relative Total Return And U.S. 2Y Yield (left); Relative Dividend Yield (right)



Note: Custom Yield Index (see Appendix 1) includes 20 stocks from Canada and 20 from the U.S with four Financial stocks, and three each from Energy Infrastructure, Utilities, Communications and REITs. Relative Dividend Yield looks at the average yield of these Canadian stocks divided by the average for the U.S. stocks. Source: Bloomberg, FactSet, and CIBC World Markets Inc.

Canadian equity yield has been punished more.

Our point is simply that Canadian dividend payers have been more impacted by rising rates than have comparable U.S. high dividend yielders. This makes sense as Canadian investors have traditionally been much more likely to use equities for "running yield" given the dearth of liquid alternatives, so the spike in rates has been more impactful in Canada.

In the past, we have even described the Canadian equity market as "our undercover high yield market" (**link**) given the high dividend yield and tax-advantages offered to dividends vis-à-vis interest income. In our opinion, that characterisation has been diluted by the factors described above but will again become a valid description if rates fall as we expect.

The Shift Back Into Dividend Payers Has Begun

Given our thesis that the surge in interest rates has disproportionately damaged Canada's high yield sectors, it makes sense that the recent fall in rates across the curve would argue for a reversal. This has already begun - or arguably has already happened.

The rotation has begun as rates have started falling.

In Exhibit 3, we show that since rates started falling from the end of April, we have seen Real Estate and Utilities outperforming the benchmark. We would note that Consumer Staples have actually led all sectors - consistent with our latest Quant report on the outperformance of Low Volatility strategies (which also win from falling rates).

In the U.S., Utilities and Real Estate have also performed strongly, though we make the case that the inclusion of some of the Magnificent Seven in sectors outside of Information Technology does make the comparison of "yield sectors" less useful.

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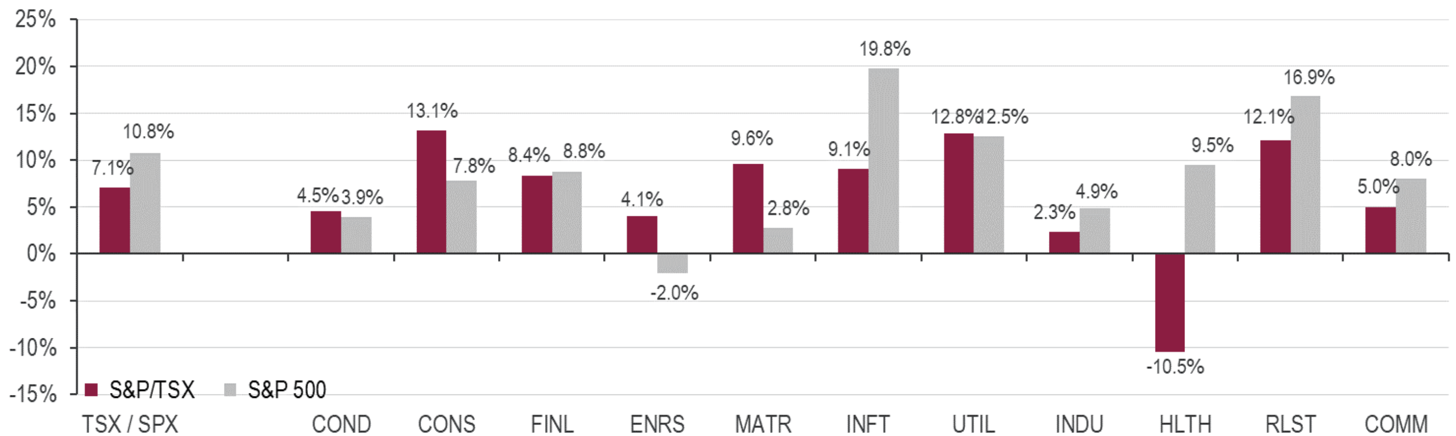
Exhibit 3: GICS Sectors Total Return Performance, Since April 30, 2024



Source: Bloomberg and CIBC World Markets Inc.

For dividend-oriented investors and portfolio managers, the rotation has been a welcome change from the dominance of tech stocks – some of which pay no dividends. To consider whether the recent move has been excessive, in Exhibit 4 we compared the performance of various GICS in the recent period (bold and in italics), with previous periods of falling rates.

Exhibit 4: Total Return Performance – By GICS Sector During Periods Of Decline Interest Rates, 2002-Current

Start	End	SPTSX	COND	CONS	FINL	ENRS	MATR	INFT	UTIL	INDU	HLTH	RLST	COMM
	Incidence	N/A	38%	54%	62%	23%	77%	62%	77%	69%	38%	77%	62%
	Average	3.9%	2.8%	11.4%	2.7%	-0.8%	14.8%	14.2%	13.7%	5.9%	-8.5%	8.6%	11.1%
	Median	7.1%	5.9%	9.0%	0.9%	-1.1%	17.1%	9.1%	11.9%	5.8%	-16.2%	12.1%	9.8%
4/30/2024	***8/16/2024***	***7.1%***	***4.5%***	***13.1%***	***8.4%***	***4.1%***	***9.6%***	***9.1%***	***12.8%***	***2.3%***	***-10.5%***	***12.1%***	***5.0%***
11/8/2022	4/4/2023	4.6%	5.9%	9.0%	0.3%	-5.5%	17.1%	34.8%	2.0%	5.8%	-16.2%	5.2%	6.1%
10/5/2018	8/10/2020	10.5%	-0.5%	33.3%	-3.7%	-24.6%	62.3%	163.6%	44.8%	14.7%	-60.6%	-0.6%	9.8%
6/26/2015	7/6/2016	-0.7%	-10.0%	9.5%	0.9%	-3.7%	25.7%	3.6%	20.1%	1.7%	-84.2%	5.4%	17.1%
9/10/2013	1/30/2015	19.3%	41.8%	57.4%	19.3%	-1.1%	6.5%	50.7%	29.4%	43.4%	72.5%	38.9%	31.5%
3/4/2011	1/6/2012	-12.5%	-12.5%	3.2%	-9.1%	-17.8%	-17.8%	-56.3%	7.9%	-1.1%	20.7%	1.2%	21.8%
4/5/2010	10/13/2010	5.5%	11.0%	4.3%	-1.5%	1.0%	21.5%	-19.6%	9.3%	7.4%	34.9%	14.5%	17.5%
6/10/2009	11/30/2009	9.5%	8.5%	6.1%	14.8%	4.1%	17.7%	-26.6%	14.3%	14.4%	23.6%	17.7%	8.1%
6/16/2008	12/30/2008	-39.8%	-23.2%	-6.7%	-34.8%	-48.5%	-39.4%	-63.6%	-23.0%	-31.0%	-25.2%	-46.4%	-18.1%
6/12/2007	3/17/2008	-3.8%	-21.1%	-17.4%	-20.3%	-0.2%	35.3%	20.0%	4.5%	-12.5%	-28.1%	-28.7%	-15.4%
6/28/2006	3/13/2007	14.9%	17.1%	10.0%	23.8%	-4.4%	25.7%	53.3%	10.0%	17.7%	2.9%	34.3%	29.4%
6/14/2004	6/27/2005	22.8%	8.3%	18.9%	21.5%	67.8%	11.6%	-18.1%	34.2%	10.0%	-22.7%	32.3%	34.6%
9/2/2003	3/23/2004	13.1%	6.3%	7.1%	16.1%	18.5%	16.1%	33.4%	11.9%	3.6%	-16.9%	26.0%	-3.2%

Note: Rate decline periods are defined as those with a fall of more than 75 bps for more than 75 days. Source: Bloomberg, FactSet, and CIBC World Markets Inc.

From our perspective, the rally so far does not look excessive. Utilities offer a useful example in Exhibit 4. In the 12 periods when long-term interest rates have fallen by over 75 bps over at least a 75-day period, Utilities have rallied on average by 13.7%, with median performance of 11.9%. The 12.8% move since May looks relatively typical. Similar comparisons for REITs and Communications also suggest the moves are not extreme.

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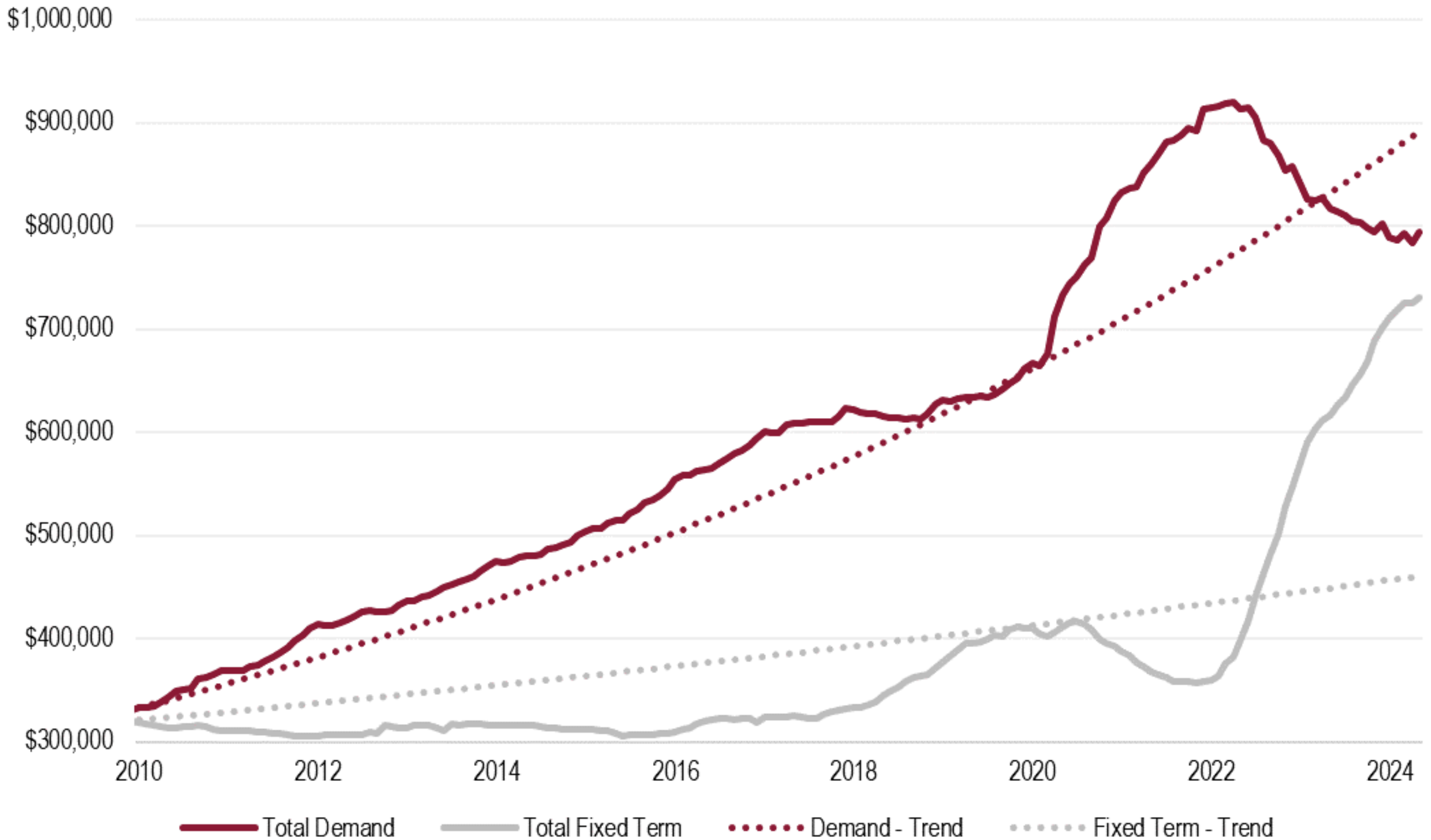
The Case For More Funds Flow In The Future

So far, we have shown Canadian yield equities were more impacted than their U.S. peers from the spike in interest rates, but that the rally since May has been quite typical. Our analysis of funds flow into other instruments suggests there is potentially much more to come.

The consumption impact of bank deposits has been well documented…

In Exhibit 5, we show Demand and Term Deposits in the Canadian banking system. Our Economics team has done an excellent job in highlighting how excess liquidity generated by COVID transfer payments provided an excellent boost to economic activity once the economy reopened. Note how Demand Deposits spiked well above their 10-year trend and then fell as the economy reopened, and excess savings were deployed into spending.

Exhibit 5: Personal Deposits In The Canadian Banking System (CAD Only), December 2010 To May 2024



Note: Trend uses average growth since 2010. Source: Bank of Canada and CIBC World Markets Inc.

…but the shift into term deposits has been less well discussed.

Equally interesting, Term Deposits [largely Guaranteed Investment Certificates (GICs)] actually fell slightly during COVID, but have significantly increased as interest rates have risen. There is an argument that investors may have simply been shifting from Demand to Term, but the scale of the increase in Term is much, much larger. Simply put, we are around $100 billion below trend in Demand Deposits, but $270 billion above trend in Term Deposits.

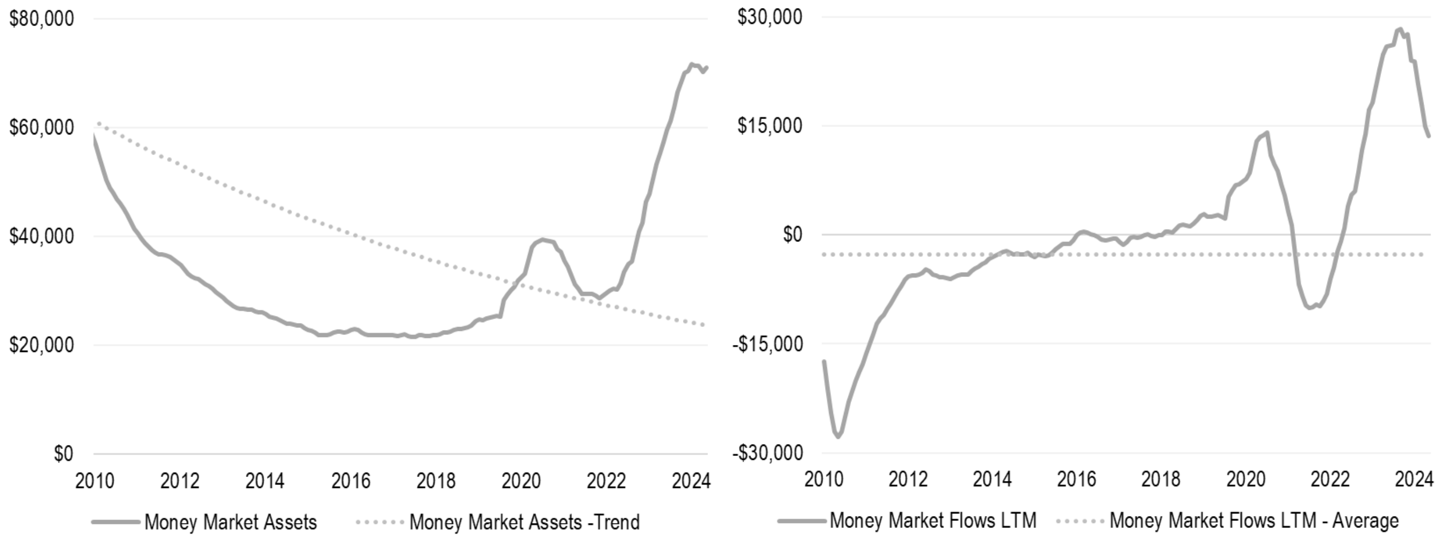
It doesn't require a leap of faith to assume this excess in Term Deposits is mainly due to the spike in rates as investors shifted "investment dollars" from alternative yield vehicles, aka Canadian dividend paying equities – short-term low-risk instruments were just too juicy!

Don't forget about HISAs and money market!

This net of $170 billion actually understates the opportunity if rates continue to fall. We must also consider incremental flow into Canadian Money Market ETFs and Mutual Funds, as well the net flow into High Interest ETFs. We show this in two ways in Exhibit 6. In the left-hand panel, we show the assets in these products as well as the trends since 2010. This suggests

there is about $50 billion of “excess” funds in these uber low-risk, short-term instruments. In the right-hand panel (flow rather than assets), it is clear some of the rotation is already occurring as rates have started to decline.

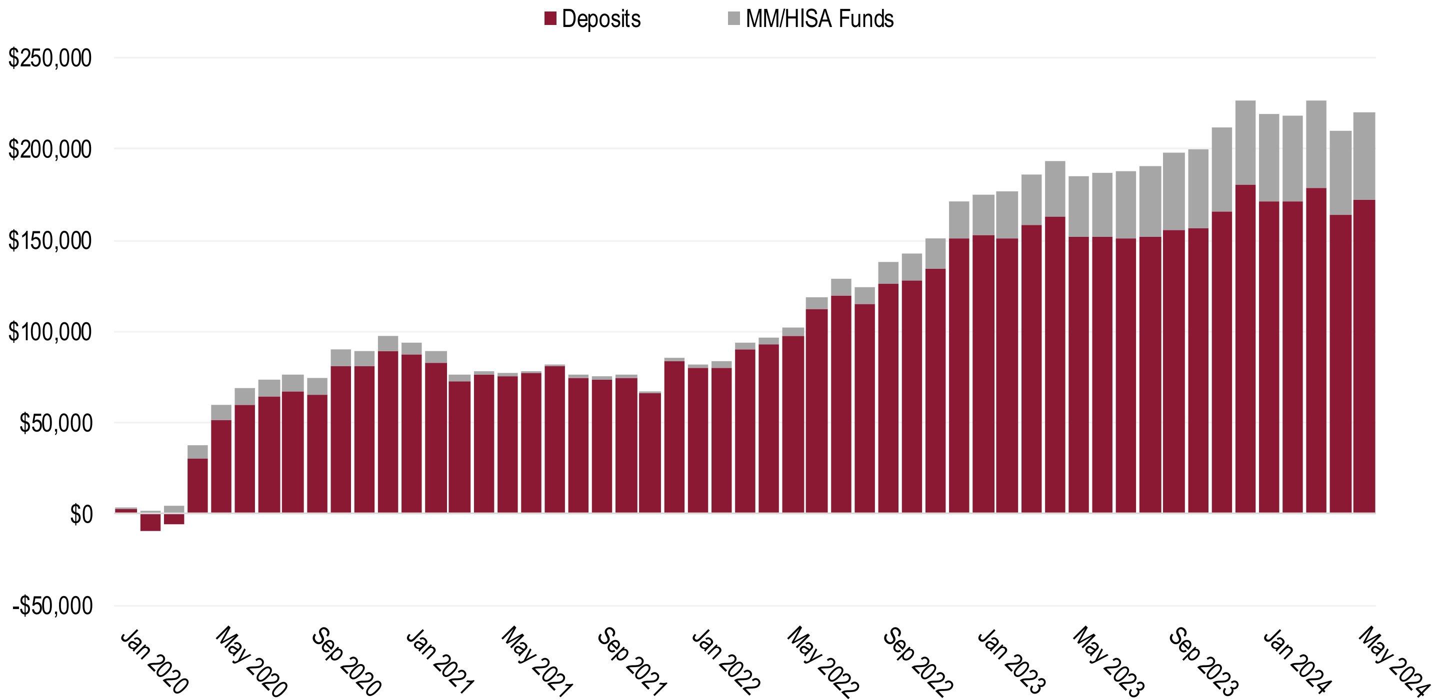
Exhibit 6: Money Market And High Interest Assets And Flows, 2010 To May 2024



Source: Bank of Canada, Bloomberg, and CIBC World Markets Inc.

Exhibit 7 combines the two “new homes” for yield investors. Note, we have focused here on “excess” (i.e., how much above trend exists in Term Deposits, Money Market and HISA products). All in all, there is clear evidence there is almost $220 billion that would typically have bought high dividend paying equities but sits in products that depend on short rates.

Exhibit 7: Excess Yield Liquidity In Term Deposits And Money Market Funds, December 2019 To May 2024



Note: MM/HISA Funds include Money Market and High Interest Savings mutual funds and ETFs. Source: Bank of Canada, Lipper, and CIBC World Markets Inc.

In Exhibit 8, we show the yield on overnight money and two-year Canadian government bonds. It is worth highlighting that it was before the turn of the century when Canadians could earn over 5% in Money Market instruments. It is scarcely surprising that investors would shun the traditional high yield stocks for short-term fixed income yield, as rates spiked to 5%.

Exhibit 8: BoC Overnight Rate And Two-year Benchmark Bond Yield, 1993 To Present

Source: Bloomberg and CIBC World Markets Inc.

Obviously, much depends on the trajectory of short-term rates in Canada. However, the trend (in Exhibit 8) is clearly lower, and with signs that the Canadian consumer is under pressure, the Bank of Canada looks highly likely to cut further. CIBC Economics currently expects 200 bps of additional short rate cuts by the end of 2025.

$220 billion that will need a new home if rates keep falling.

In Exhibit 9, we show a table with our estimate for the excess in fixed income yield and the market capitalization of the four traditional equity yield sectors – Real Estate, Utilities, Telecom and Financials. Simply put, there is as much as 15% of the current market cap of these sectors that might return if rates continue falling.

Exhibit 9: Canadian Excess Yield Liquidity And The Market Cap Of Traditional Yield Sectors (Current)

Canadian Excess Liquidity		Canadian Yield Equity Market	
Term Deposits	$171,952	Real Estate	$75,774
Money Market	$47,629	Utilities	$149,222
		Telecom	$105,311
		Financials	$1,075,030
Total	**$219,581**	**Total**	$1,405,337

Source: Bank of Canada, Bloomberg, and CIBC World Markets Inc.

Appendix 1: Equal Weighted Custom Dividend Yield Index, Composition And Current Dividend Yield

Canada	Current Dividend Yield		US
Financials			**Financials**
Great-West Lifeco Inc.	5.2%	4.1%	Prudential Financial, Inc.
Sun Life Financial Inc.	4.6%	3.3%	Principal Financial Group, Inc.
Bank of Nova Scotia	6.6%	5.1%	KeyCorp
Royal Bank of Canada	3.6%	3.4%	Morgan Stanley
Energy			**Energy**
Enbridge Inc.	7.0%	5.4%	Kinder Morgan Inc Class P
TC Energy Corporation	6.4%	4.3%	Williams Companies, Inc.
Pembina Pipeline Corporation	5.0%	4.7%	ONEOK, Inc.
Utilities			**Utilities**
Emera Incorporated	5.7%	3.1%	CMS Energy Corporation
Fortis Inc.	4.0%	2.6%	NextEra Energy, Inc.
Hydro One Limited	2.8%	3.4%	Southern Company
Communication Services			**Communication Services**
BCE Inc.	8.4%	6.6%	Verizon Communications Inc.
TELUS Corporation	6.8%	5.8%	AT&T Inc.
Rogers Communications Inc. Class B	3.7%	2.9%	Comcast Corporation Class A
Real Estate			**Real Estate**
SmartCentres Real Estate Investment Trust	7.7%	5.1%	Simon Property Group, Inc.
Crombie Real Estate Investment Trust	6.5%	4.2%	Brixmor Property Group, Inc.
RioCan Real Estate Investment Trust	6.1%	4.4%	Kimco Realty Corporation

Source: FactSet and CIBC World Markets Inc.

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